

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1976



No.

76-4241

SAIA ELECTRIC, INC.,

Petitioner

Versus

COMMISSIONER OF INTERNAL REVENUE,

Respondent

PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

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INDEX

Page No.

AUTHORITIES	ii
OPINIONS BELOW	1
JURISDICTION	2
QUESTIONS PRESENTED.....	2
STATUTES INVOLVED	2
STATEMENT OF THE CASE	4
REASONS FOR GRANTING THE WRIT	5
I. The Regulations of the Commissioner Preclude Existence of Bona Fide Arms Length Compensation Agreements Between Corporations and Controlling Stockholder - Employees	5
II. Reasonable Compensation Issue Is Applied and Enforced In a Discriminatory Manner Against Closely Held Corporations	7
CONCLUSION	11
CERTIFICATE OF SERVICE	12
APPENDIX A—OPINION OF FIFTH CIRCUIT..	13
APPENDIX B—OPINION OF TAX COURT.....	14

AUTHORITIES

Page No.

CASES

<i>Moline Properties,</i> 63 S. Ct. 1132 (1943)	5, 6
<i>Nortlich Stolley, Inc. vs. U.S.,</i> 368 F 2d 272 (Ct. Cl. 1966)	10
<i>Saia Electric, Inc.,</i> T C. Memo 1974-290	1, 8

STATUTES

Section 162, Internal Revenue Code	2, 5, 10
28 U.S.C. 1254(1)	2

MISCELLANEOUS

1.162-7, Income Tax Regulations	2, 3, 5
Business Week, May 4, 1974	8

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Petitioner, Saia Electric, Inc., appearing through counsel respectfully petitions this Honorable Court for a Writ of Certiorari to review a decision of the United States Court of Appeals For The Fifth Circuit rendered in this cause on July 16, 1976.

OPINIONS BELOW

The decision or opinion of the United States Court of Appeals For The Fifth Circuit was entered on July 16, 1976 and is reproduced as Appendix A, page 13, infra. The decision has not yet been reported. The opinion of the United States Tax Court, from which the appeal was taken, was entered on November 18, 1974 and is reproduced herewith as Appendix B, page 14, infra. This decision is reported in T. C. Memo 1974-290.

JURISDICTION

The decision or opinion of the United States Court of Appeals For The Fifth Circuit was rendered on July 16, 1976. A Petition For Rehearing was timely filed and was denied on August 9, 1976. This Petition For Certiorari is being filed less than 90 days from the date the Petition For Rehearing was denied. The jurisdiction of this Court is invoked under the provisions of Title 28 United States Code, Section 1254(1).

QUESTIONS PRESENTED

I. Whether Income Tax Regulations 1.162-7 promulgated by the Commissioner of Internal Revenue under Section 162 of the Internal Revenue Code are valid in determining what constitutes reasonable compensation since they preclude existence of arms length compensation agreements between corporations and controlling stockholder-employees.

II. Whether Income Tax Regulations 1.162-7 are valid since they are applied and enforced only against closely held corporations and not against publicly held corporations in the matter of compensation paid to shareholder-employees of such corporations.

STATUTES INVOLVED

Section 162(a)(1) of the Internal Revenue Code which provides:

"(a) In General—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including —

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

Section 1.162-7 of the Income Tax Regulations which provides:

"Compensation for personal services.

(a) There may be including among the ordinary and necessary expenses paid or incurred in carrying on any trade or business a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.

(b) The test set forth in paragraph (a) of this section and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. *This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries.* If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from

that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned."

*** (Emphasis added)

STATEMENT OF THE CASE

Petitioner is a corporation organized under the laws of the State of Louisiana and is engaged in the electrical contracting business at Baton Rouge, Louisiana. Petitioner is a closely held corporation since, for the tax year at issue, 98.7% of its stock was owned by its President and Chief Executive Officer.

Petitioner was organized on March 17, 1960 by Frank "Tickie" Saia who has continued through the years as an employee and President of the Company. For the tax year ending February 28, 1969, petitioner paid this employee \$301,293.00 in accordance with the terms of a written em-

ployment contract dated March 1, 1965. Under the terms of this contract, petitioner pays Saia 40% of its net earnings in any given fiscal year as compensation for his services. There is no minimum or guaranteed amount payable to Saia—his compensation is exclusively contingent on the earnings of petitioner.

It is an accepted finding of fact that Saia is a full-time employee of petitioner and is credited with the responsibility of having established petitioner as a highly successful departmentalized business corporation.

Respondent contends the compensation paid Saia by petitioner is excessive under Section 162 of the Internal Revenue Code and the regulations promulgated thereunder.

REASONS FOR GRANTING THE WRIT

I. The Regulations of the Commissioner Preclude Existence of Bona Fide Arms Length Compensation Agreements Between Corporations And Controlling Stockholder-Employees.

It is the position of petitioner that the Income Tax Regulations 1.162-7 promulgated by the Commissioner of Internal Revenue under Section 162 of the Internal Revenue Code in determining what constitutes reasonable compensation are contrary to law and, therefore, invalid.

In the case of *Moline Properties*, 63 S. Ct. 1132 (1943), this Court held that a corporation is an entity which exists separate and apart from its stockholders and cannot be ignored for federal income tax purposes. The regulations promulgated by the Commissioner of Internal Revenue quoted above, contrary to the holding of the *Moline* case, disregard the corporate entity in the case of closely held corporations in the matter of determining what constitutes reasonable compensation paid by such corporations to controlling stockholder-employees.

The effect of the cited regulation is that there can be

no arms length bargaining agreement between a corporation and its controlling shareholder in matters of compensation. In this connection, the United States Tax Court in the instant case said:

" . . . where the compensation is paid to the employee who controls the corporation special scrutiny must be given to such salaries for there is a lack of arm's length bargaining *as required by the regulations*.

This type of examination is needed because it would be a simple matter for the owner-employee to take the corporate profits out in the form of deductible compensation rather than dividends.

*****"

(Emphasis added)

Based upon the above reasoning, the United States Tax Court disregarded the written agreement existing between petitioner and Saia and independently determined what constituted a reasonable compensation for his services.

Petitioner contends that the above regulation as so interpreted and applied is contrary to law as expressed by this Court in the *Moline* case and is, therefore, invalid. The regulation prohibits a controlling stockholder-employee from negotiating compensation for his services and at the same time prohibits him from disregarding the corporate entity and claiming as his own the profits he primarily earned. Such rules have the legal effect of placing a controlled corporation beyond any rational position. The corporation profits from the efforts and resources of the individual who creates the entity, gets the business, performs the corporate duties, endorses and guarantees the corporation's obligations and performances, yet the individual cannot benefit from his sacrifices because no free bargain and arms length negotiations exist in the determination of his compensation. He is

simply penalized for his stock ownership. The rule assumes that once a corporation is created, the entity immediately becomes self-sufficient, independent, mutually exclusive, and has no need for key people. This is, of course, a fallacy. Such corporations are in fact dependent upon individuals having the skills, financial know-how, and resources to enable the corporation to achieve financial success. It is not the individuals behind successful corporations who depend upon them for security; rather it is the corporations who depend upon the talents and resources of individuals for their success. Such individuals can and do have the capacity to negotiate and enter into arms length bargaining agreements with corporations controlled by them, yet the regulations of the Commissioner preclude this possibility.

It was noted by the Tax Court in this case that Saia was primarily responsible for petitioner's success. Saia did in fact commit his full efforts and personal resources in order that petitioner could benefit therefrom, which included, among other things, personally endorsing and guaranteeing payment and performance of petitioner's debts and contract obligations. The Compensation agreement was entirely contingent upon the earnings of the corporation. Such agreements, petitioner contends, are primarily beneficial to the corporation since they underwrite and insure corporate success prior to payment of compensation to the controlling employee whose duty it is to concern himself with profit making. Such agreements cannot, per se, be said to have been executed without the benefit of free bargaining relationships between the parties.

II. Reasonable Compensation Issue Is Applied And Enforced In a Discriminatory Manner Against Closely Held Corporations.

Compensation paid by a closely held corporation is given special scrutiny for ". . . it would be a simple matter for the owner-employer to take the corporate profits out in the form of deductible compensation rather than dividends."

Saia Electric, Inc. v. Commissioner, T. C. Memo 1974— Paragraph 290. In audits of closely held corporations, compensation is an inviting subject for Agents. The reported cases on reasonable compensation involve only small closely held corporations and not publicly held corporations. Petitioner asserts that Internal Revenue Service audit policies and regulations discriminate against small business corporations and penalize the ownership of stock in such corporations.

There appear no reported cases wherein the Government has attacked the larger publicly held corporations for paying substantial amounts to their Board Chairmen and executive officers. Recently the Judicial Conference of the United States published a booklet on the low salaries of Federal Judges and listed therein salaries of the ten (10) highest paid executives in the United States. Salaries for executives ranged from \$200,000 to \$950,000 including indirect compensation. In 1973, General Motors paid compensation to its Chairman in excess of \$900,000. cf. also *Business Week*, May 4, 1974, p. 58-65. Yet, compensation for such individuals is not considered unreasonable. One of the highest paid executives in the United States, according to the Judicial Conference study, was Henry Ford whose family exercises working control of Ford Motor Company.

Another case in point are the large salaries paid professional athletes who only work in season during the year.

In the case before the Court, petitioner's chief executive, Saia, was officially named and designated the Nation's Small Business Man of the Year for 1969, as shown by the record. This coveted and prestigious award recognized outstanding individual ability and accomplishments by Saia in building Petitioner in a short period of time.

However, Respondent and the Tax Court say that Saia can only receive \$175,000.00 in compensation because he controls and built the employer; that Saia's total compen-

sation cannot reach even the lowest of the ten (10) highest paid executives in America; that what Saia received is unreasonable because he controls Petitioner even though petitioner paid dividends which would produce a yield equal to or in excess of that which an investor would receive in a publicly held corporation.

The Tax Court's holding is nothing less than sheer discrimination against small business and individual ownership and incentive. Petitioner cannot depend on a worldwide network of dealers and echelon after echelon of corporate managers, directors, specialists, engineers and unlimited financial resources. It depends upon Saia. Petitioner's total administrative force began with four (4) people including Saia's wife and in 1969 this number totaled eight (8) full time people. Yet its profits have been exceptionally good. It is submitted that Saia for his efforts and as the number one small businessman in the United States is entitled under the doctrine of fairness and equal justice to compensation at a level equal to any one of the ten (10) highest paid executives in America, but not less than \$301,292.85. At least he should not be discriminated against or punished financially because he controls Petitioner.

Perhaps the most onerous tax burden of a controlled corporation is to establish conformity with the realities of financial and business life and the audit policy of Internal Revenue on compensation of key stockholder employees. A fortiori. Petitioner respectfully submits that Internal Revenue Service policy and decisional law on the issue compels a legal impossibility and indicates calculated, rank and overt discrimination against small business corporations, their employee-stockholders, and ownership in general. Petitioner urges this Honorable Court to restore some degree of justice on the point at issue by putting an end to legal discrimination and preference of large publicly held corporations over small corporations and their officers.

Nothing in the legislative history of Section 162(a)(1) indicates that Congress intended the term "reasonable" to be applied only to controlled corporations. It is submitted that the statute has general, not limited application, and the Commissioner's regulations are not fairly interpretative of the provision and are discriminatory. The statute and its legislative history does not direct or compel that ownership should be penalized. It does not provide for a distinction of application to small versus large corporations, and petitioner urges that this Court prevent its being so applied.

The arguments of respondent where contingent compensation agreements are concerned generally follow the theory of *Northlich Stolley, Inc. vs. U.S.*, 368 F. 2d 272 (Ct. Cl., 1966), and are to the effect that "bonus-type" compensation might be reasonable between a non-stockholder-employee but unreasonable if made with a large stockholder "since the incentive of the bonus would presumably not be needed to call forth the stockholder's best efforts." In other words, control of a corporation is all that is required to produce incentive under this reasoning. The owner is allowed only that which the Government thinks he is worth where the shareholder-employee controls the corporation. We submit that such is not the law. Incentive cannot be purchased like a loaf of bread. It must be earned or given freely. Again, the preoccupation of the Internal Revenue Service with the question of discrimination is evident. Cases like *Northlich* demonstrate the need to re-examine this theory of incentive and reiterates the need to examine the corporate motive and circumstances which resulted in the compensation agreement in question.

Petitioner respectfully urges that the Tax Court's decision unreasonably discriminates against small business corporations, and is a penalty against stock ownership.

CONCLUSION

For the above and foregoing reasons, petitioner prays that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for The Fifth Circuit.

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COUNSEL FOR PETITIONER

CERTIFICATE OF SERVICE

I, David Irvin Couvillion, counsel for petitioner, in the foregoing application for writ of certiorari, do hereby certify that I have served copies of the foregoing application for writ on:

Hon. Robert H. Bork
Solicitor General
Department of Justice
Washington, D. C. 20530

and

Hon. Scott P. Crampton
Assistant Attorney General
Department of Justice
Tax Division
Washington, D. C. 20530

by mailing copies thereof, through the United States Mail, postage prepaid, addressed to their respective offices on the 21st day of September, 1976.

All parties required to be served have been served.

s/ David Irvin Couvillion
DAVID IRVIN COUVILLION

APPENDIX A

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 75-1954

SAIA ELECTRIC, INC.,

Petitioner-Appellant,

versus

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appeal from the Decision of the United States Tax Court
(Louisiana Case)

(July 16, 1976)

Before RIVES, GOLDBERG, and GEE, Circuit Judges.

PER CURIAM: AFFIRMED. The decision of the Tax Court is affirmed on the basis of the Tax Court's opinion. *Saia v. Commissioner of Internal Revenue*, T. C. Memo. 1974-290.

APPENDIX B

T. C. Memo. 1974-290

UNITED STATES TAX COURT

SAIA ELECTRIC, INC., Petitioner *v.* COMMISSIONER
OF INTERNAL REVENUE, Respondent

Docket No. 2050-73 Filed November 18, 1974.

Based on all the facts presented, compensation paid by petitioner to its president and major shareholder was unreasonable and excessive. *Held*: Reasonable compensation determined.

Theodore L. Jones and Kenneth Addison Duncan, for the petitioner.

Paul H. Waldman, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

STERRETT, *Judge*: Respondent determined a deficiency in the corporation income tax of Saia Electric, Inc. for the taxable year ended February 28, 1969 in the amount of \$106,282.68.

The sole issue for decision is whether respondent erred in determining that a portion of the deduction on Saia Electric, Inc.'s income tax return for compensation to its president and major shareholder was unreasonable and excessive and therefore not within the ambit of section 162(a)(1) of the Internal Revenue Code of 1954.¹

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts, together with the exhibits attached thereto, are incorporated herein by this reference.

Saia Electric, Inc. (hereinafter petitioner) is a corporation organized under the business corporation laws of the State of Louisiana, and whose principal place of business was 6175 Confidence Street, Baton Rouge, Louisiana at the time of filing its petition herein. Petitioner was organized on March 17, 1960, for the primary purpose of engaging in and conducting the business of an industrial electrical contractor. Petitioner maintains its books and records and files its income tax return using the completed contract method of accounting.

From inception through to and including the taxable year in issue, Frank J. Saia (hereinafter Saia) was the president and major stockholder of petitioner. During the fiscal year ended February 28, 1969, Saia owned 98.7 percent of the petitioner's outstanding capital stock.

Saia first acquired experience in the electrical contracting business by working for Sachse Electric, Inc. (hereinafter Sachse) in Baton Rouge, Louisiana. He began as a truck driver and part-time helper in 1941. After a period of military duty, he returned to Sachse in 1945. Saia made steady progress in the company starting out as a truck driver, working as an apprentice electrician and as a warehouseman, and finally becoming general manager and vice president.

As general manager and vice president of Sachse, Saia had multiple responsibilities. He solicited a large majority of the contracts, supervised the job department that estimated and priced prospective jobs, supervised technical and

¹ All statutory references are to the Internal Revenue Code of 1954, as amended.

field personnel, assigned the manpower to the various jobs, and supervised the purchasing department. Saia also traveled throughout the United States and abroad representing Sachse and handled various labor relation problems.

For these services Saia in 1958 and 1959, his last 2 years with Sachse, received approximately \$1,000 per week in salary and bonuses. He also received fringe benefits which included a life insurance policy and a retirement plan. In 1958 Saia was granted an option, with favorable terms, to acquire control of Sachse from the Sachse family on the death of Maurice B. Sachse, the president of the company. The option terminated when Saia ended his employment with Sachse.

In the latter part of 1959, Saia had an accident for which hospital care was needed. Upon his return to work in the early part of 1960, disagreements arose, and Saia left the company to form petitioner. Saia formed petitioner in March, 1960 with \$15,400, of which \$10,000 was borrowed. Saia was the sole shareholder and president.

Petitioner's beginnings were modest. It started with four basic employees—Saia, as president, was in charge of all phases of the business, Grace P. Saia, Saia's wife, helped in the office, Rocco J. DeBenedetto, Jr. (hereinafter DeBenedetto) served as Saia's assistant, and a gentleman who left Sachse with Saia was an estimator. Saia does not have a college degree or any degree in engineering.

After its first fiscal year, which ended on February 28, 1961, petitioner's tax return showed gross receipts of \$199,204.70 and taxable income of \$13,360.26.² Saia's compensation for the year was \$6,425. By the end of fiscal year February 28, 1965, petitioner's tax return showed gross receipts of \$1,007,165.52 and taxable income of \$80,121.51.

² After an Internal Revenue Service audit taxable income was increased by \$792.75 caused by disallowance of some deductions.

Saia's compensation for the year was \$54,397.85.³ Also reported was a cash distribution of \$5,966.80. During this period Saia received a salary and a bonus based on 20 percent of the net profits.

On March 1, 1965, a special meeting of petitioner's board of directors was held. In attendance were Saia, Grace P. Saia, and Etta Marie Saia (Saia's sister). The purpose of the meeting was to consider an "Executive Employment Contract" between petitioner and Saia. Under the terms of the proposed contract Saia was to receive 40 percent of the net profits of the petitioner after deducting all costs and expenses except income taxes and Saia's compensation. The contract was to last 2 years with month-to-month extensions thereafter until the agreement was terminated. Upon presentation to the board of directors a resolution approving this proposed compensation contract was unanimously adopted. The contract was then signed by Saia on behalf of the petitioner and by Saia in his individual capacity.

An additional provision to the contract was later proposed and adopted by petitioner's board of directors at its regular annual meeting. The addendum provided:

Any payment made to Frank J. Saia pursuant to his employment contract dated March 1, 1965, or any payment to him or any other officer of the Corporation, for compensation, bonuses, interest, rent, travel, entertainment, or other expenses incurred by him that is determined to be excessive, unreasonable or otherwise unallowable, in whole or in part, as a deductible expense, such officer shall have an unconditional obliga-

³ After an Internal Revenue Service audit of Saia's individual tax returns for the years 1960, 1961, and 1962, additional amounts of \$512.75, \$2,415.30, and \$2,054.50, respectively, were included as dividends received from petitioner, caused by petitioner paying for personal expenses of Saia.

tion to reimburse the Corporation to the full extent of such unallowable expense.

Since the adoption of this contract, Saia's compensation has been calculated according to its terms. Petitioner's tax returns for the taxable years ending February 28, 1966, through February 28, 1969, show the following figures:

Fiscal Year February 28	Gross Receipts	Taxable Income	Total Officers' Compensation	Saia's Compensation	DeBenedetto's Compensation	Retained Earnings
1966	\$1,491,199	\$123,566	\$112,225	\$ 91,600	\$15,225	\$274,059
1967	3,040,614	277,515	228,775	203,485	18,400	334,389
1968	2,525,453	219,317	197,691	162,662	20,130	446,213
1969	4,614,260	405,548	343,298	301,293	22,675	643,484

During this period Saia devoted his full time to petitioner and as president was responsible for all affairs pertaining to it, including promotional activities and developing its bids for prospective contracts. Petitioner's success was due largely to his efforts. DeBenedetto also devoted his full time to petitioner and as vice president and general manager he had multiple duties, including supervisory responsibilities over the administrative and construction departments.

During this period petitioner's dividend history was as follows: ⁴

Fiscal Year Ended February 28	Cash	Stock
1966	\$ 942	100,000
1967	2,314	144,300
1968	15,600	—
1969	28,600	70,200

Beginning in the middle of 1965, petitioner's business began to change. In the past Saia had been able to secure business for petitioner by pledging his personal guarantee. However, Saia advised the board of directors that the quantity and size of the recent available business was making the financial condition of the corporation more important than the financial condition of the individuals involved. For such business petitioner would be competing with larger firms. To compete successfully with these firms and for other reasons, Saia advised that petitioner be in a strong cash position.

⁴ Petitioner's summary of its dividend history, prepared by its accountant from the audit reports and tax returns for this period, shows some variation from the above figures. It is not entirely clear from the record why this variation occurred, but in any case it is minimal and has no bearing on the outcome herein.

As the nature of petitioner's business changed its staff grew and became departmentalized. During fiscal year 1969, petitioner's organization chart reflected the following positions and compensation levels:

Position	Compensation on Calendar Year Basis
president	\$301,293 ^a
vice president and general manager	26,400
secretary-treasurer	20,305
assistant secretary-treasurer and controller	8,040
electrical engineer	14,305
purchasing agent	13,615
general superintendent	14,397
utility division manager	12,515

A separate individual was in charge of each position and was responsible for the individuals in his department. The functions of these positions were established and day-to-day activities were performed with authority and discretion by the responsible individual. Major decisions were referred to Saia.

Petitioner's style of growth is exemplified by the growth of the utility line division. In 1965 this department was managed by Russell Saia, Jr. At that time there were three line crews, one truck, and approximately 20 workers. By 1969 there were eight line crews, two trucks, and approximately 60 workers. Russell Saia, Jr. had sole responsibility for hiring and firing workers. He handled labor problems at the steward level, and occasionally consulted with his supervisor, DeBenedetto. Saia handled the problems that could not be resolved by Russell Saia and DeBenedetto.

^a Represents Saia's compensation for the fiscal year in issue.

According to the terms of the compensation contract, Saia's compensation for fiscal year 1969 was \$301,292.95. Petitioner deducted that amount on its tax return filed for that taxable year. Respondent determined \$100,000 to be a reasonable salary or other compensation for personal services actually rendered by Saia within the meaning of section 162. Consequently petitioner's income was increased by \$201,292.95, which correspondingly increased petitioner's federal tax liability.

OPINION

Section 162(a)(1) provides that in computing its taxable income a corporation shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including "a reasonable allowance for salaries or other compensation for personal services actually rendered." The sole question presented for our decision is whether the amount paid as compensation by the petitioner corporation to its president and controlling shareholder was reasonable under the terms of section 162(a)(1), and therefore deductible.

Petitioner compensated Saia for his services according to the terms of the employment contract entered into in March, 1965. Petitioner asks us to respect the terms of the contract as being made by two independent parties, and to hold that the resulting compensation is reasonable and therefore fully deductible. Support for this position can be found in the regulations to section 162. Income Tax Regs. section 1.162-7(b) provides:

(2) The form or method of fixing compensation is not decisive as to deductibility. *** Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other

than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) *** The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

However, Income Tax Regs. section 1.162-7(b)(3) restricts this providing that "[i]n any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances." Consequently compensation determined "pursuant to such *** [a contingent] agreement is not inherently reasonable." *Charles Schneider & Co., Inc. v. Commissioner*, 500 F. 2d 148, 152 (8th Cir. 1974), affirming a Memorandum Opinion of this Court.

Furthermore, where the compensation is paid to the employee who controls the corporation special scrutiny must be given to such salaries for there is a lack of arm's length bargaining as required by the regulations. *Charles Schneider & Co., Inc., supra*, *Miller Box, Inc. v. United States*, 488 F. 2d 695 (5th Cir. 1974), *The Barton-Gillet Company*, 442 F. 2d 1343 (4th Cir. 1971), affirming per curiam a Memorandum Opinion of this Court. This type of examination is needed because it would be a simple matter for the owner-employee to take the corporate profits out in the form of deductible compensation rather than dividends. On the other hand the reasonableness of the compensation paid to an owner-employee who renders valuable services should not be limited simply because the employee is also the owner

and could have taken a part of the amount paid him in the form of dividends.

The burden of proving reasonableness is upon the petitioner. *Botany Worsted Mills v. United States*, 278 U.S. 282 (1929), and the question is one of fact to be determined from all the facts and circumstances of the particular case. *Charles Schneider & Co., Inc., supra*, *Boyle Fuel Co.*, 53 T.C. 162, 169 (1969). As stated in *Mayson Mfg. Co. v. Commissioner*, 178 F. 2d 115, 119 (6th Cir. 1949), reversing a Memorandum Opinion of this Court, the relevant facts and circumstances may be summarized as follows:

Such factors include the employee's qualifications; the nature, extent and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid with the gross income and the net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions in comparable concerns; the salary policy of the taxpayer as to all employees; and in the case of small corporations with a limited number of officers the amount of compensation paid to the particular employee in previous years. ***

In appraising the reasonableness of Saia's salary we are disturbed by several factors. First, as Saia noted himself in May, 1975, only a few months after the compensation contract was adopted, the nature and quality of petitioner's business was changing. As the petitioner competed for larger contracts, its organization and abilities would be more important than Saia's personal influence. This attitude is reflected by petitioner's growth and the delegation of authority throughout the organization. At trial, respondent's witnesses testified that contracts were awarded to petitioner with the knowledge that certain employees would be responsible for field work. Consequently we believe that Saia's personal ef-

forts were not responsible for all of petitioner's profits and therefore not all of Saia's compensation was for "personal services actually rendered." See *Miller Box, Inc., supra*.

Having said that, we should point out that the record makes it clear that Saia was primarily responsible for petitioner's success. After petitioner was formed he was active in every phase of the business. He generated the major portion of petitioner's work. Even as petitioner grew, Saia continued to work full time retaining ultimate authority over its operations. Saia should also be given credit for creating the organization that enabled petitioner to compete successfully with larger companies. We have no doubt that Saia rendered valuable services for petitioner, and they have an impact on the final determination.

Secondly, we are concerned by petitioner's low level of cash dividend distributions.* For the fiscal year 1969, petitioner had taxable income of \$706,841 before Saia's compensation. Petitioner's cash distribution during this year was \$28,600 or approximately 4 percent of taxable income available for distribution. During this period and in prior years, petitioner's cash position was of constant concern to the board of directors. Even though the cash distribution for fiscal year 1969 represents an increase over prior years, we think it significant that petitioner's dividend distributions bore the brunt of this concern while Saia's compensation formula remained unchanged.

In this area we also consider relevant the provision added to the employment agreement after it was adopted. The agreement required any officer to repay to petitioner amounts received under the agreement but which were later declared to be excessive, unreasonable, or otherwise unlawful. This provision could reflect a pre-existing knowledge by petitioner that the payments would not be reason-

* Petitioner's stock dividends are not relevant for this determination since they only represent a shift in its capital structure.

able for tax purposes and could lead to an inference as to their intent. *Charles Schneider & Co., Inc., supra* at 155.

Finally we are concerned about petitioner's salary policy with regard to its other officers and key employees. Over the years DeBenedetto gradually assumed additional responsibilities and during fiscal year 1969 he served as vice president and general manager. Yet his salary remained relatively stable and it does not appear that his compensation appropriately reflected his contribution to petitioner's success. In addition, the total compensation paid (including bonuses) by petitioner to its other officers and key employees was \$109,577, while Saia's compensation was \$301,293. We find it difficult to believe that Saia's services were worth approximately three times that of the other key employees combined.⁷ We also consider relevant the fact that Saia was the only officer who received contingent compensation. Petitioner had other individuals in responsible positions, yet contingent compensation arrangements were not necessary to secure their services.

In support of his determination, respondent has introduced data about other firms in the electrical contracting business. This information shows that the presidents of these companies earned approximately \$100,000 per year. Admittedly the information presented does not disclose the duties performed by these individuals. Our determination of this controversy necessarily depends heavily on the factual pattern as presented before this Court. Consequently, we find respondent's data helpful, but have not placed complete reliance on it in reaching our decision herein.⁸

We recognize the value of Saia's services to petitioner. As we have noted he was largely responsible for its success.

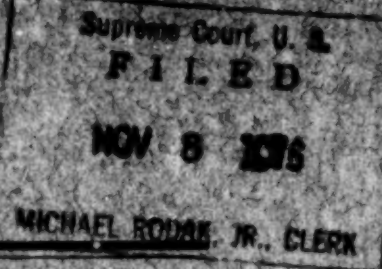
⁷ We are aware that this represents a comparison of calendar year and fiscal year compensation figures respectively. However, we do not believe that a material distortion is created.

For this reason we cannot accept undisturbed the respondent's determination as to what constitutes reasonable compensation. We attempt the delineation of reasonable compensation in the knowledge that we are not bound to fix the amount with mathematical precision. *Jones Brothers Bakery, Inc. v. United States*, 411 F. 2d 1282, 1294 (Ct. Cl. 1969). Accordingly, based on our findings of fact, we find reasonable compensation for Saia's services rendered during fiscal year 1969 to be \$175,000.

*Decision will be entered
under Rule 155.*

⁸ In this vein, we also believe petitioner's reliance on *John Miller Electric Company, Inc.*, a Memorandum Opinion of this Court dated November 26, 1945, which we find to be factually distinguishable, to be of little probative value.

No. 76-424



In the Supreme Court of the United States

OCTOBER TERM, 1976

SAIA ELECTRIC, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

**ON PETITION FOR A WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS FOR
THE FIFTH CIRCUIT**

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

**ROBERT H. BORK,
Solicitor General,
Department of Justice,
Washington, D.C. 20530.**

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The sole question presented in this federal income tax case is whether part of the purported compensation paid by petitioner to its chief officer and controlling shareholder was unreasonable and therefore not deductible under Section 162(a)(1) of the Internal Revenue Code of 1954 (26 U.S.C.).

The pertinent facts are as follows: Petitioner is in the electrical contracting business. Its president and controlling shareholder was Frank J. Saia, who owned 98.7 percent of petitioner's stock (Pet. App. B 15). Pursuant to a contingent compensation agreement, petitioner annually paid Saia 40 percent of its net earnings (computed before deducting income taxes or Saia's salary) (Pet. App. B 17). For the taxable year ended February 28, 1969, petitioner paid Saia \$301,292.95 under the compensation agreement and claimed a deduction for that amount on its corporate

tax return. On audit, the Commissioner of Internal Revenue determined that Saia's compensation was unreasonable to the extent it exceeded \$100,000 and reduced petitioner's claimed deduction to that amount (Pet. App. B 22).

In appraising the reasonableness of petitioner's compensation to Saia, the Tax Court considered the nature of Saia's work, the size and complexity of petitioner's business, the prevailing rates of compensation for comparable positions in other firms, petitioner's salary policy with regard to its nonstockholder employees, and petitioner's dividend history. Based upon an analysis of these factors, the court concluded that \$175,000 was the maximum amount allowable as reasonable compensation that could be deducted under Section 162 of the Code (Pet. App. B 27). The court of appeals affirmed *per curiam* (Pet. App. A 13).

There is no basis for further review of the factual question of the reasonableness of petitioner's compensation to its chief officer who was also its controlling shareholder.

Petitioner challenges (Pet. 6) the Tax Court's statement that salaries paid by corporations to their controlling shareholders should be carefully scrutinized in order to insure that such salaries are not in fact disguised dividends. But that proposition is in accord with numerous appellate decisions as well as the applicable Treasury Regulations. See, e.g., *Charles Schneider & Co., Inc. v. Commissioner*, 500 F. 2d 148 (C.A. 8); *Miller Box, Inc. v. United States*, 488 F. 2d 695 (C.A. 5), certiorari denied, 417 U.S. 945; *Jones Brothers Bakery, Inc. v. United States*, 411 F. 2d 1282, 1293 (Ct. Cl.); Treasury Regulations on Income Tax (1954 Code), Section 1.162-7 (26 C.F.R.). Moreover, the fact that a corporation and its shareholders are separate taxable entities does not require, as petitioner suggests (Pet. 6), that the Commissioner and

the courts accept non-arm's length compensation agreements between closely-held corporations and their shareholder-employees. On the contrary, such compensation agreements are to be disregarded where the payments in question are not solely for services rendered. *Botany Mills v. United States*, 278 U.S. 282, 292.

Finally, petitioner contends (Pet. 7-10) that the decision below discriminates against closely-held corporations because the compensation arrangements of publicly-held corporations are usually not subject to the same scrutiny as those of small businesses. But the compensation paid by publicly-held corporations is subject to the scrutiny of the shareholders, who can act to prevent unreasonable amounts. Since there is unlikely to be comparable scrutiny in closely-held corporations, those firms are more likely to distribute dividends under the guise of deductible salary payments. The special scrutiny given the compensation arrangements of closely-held corporations is thus appropriate.

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

NOVEMBER 1976.